DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 00-0140
State Gross Retail Tax
For Tax Years 1996 through 1998

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ISSUES

I. State Gross Retail Tax—Utility Exclusion

Authority: IC 6-2.5-4-5(c); IC 6-2.5-5-5.1
Sales Tax Information Bulletin #55

Taxpayer protests the auditor's determination that taxpayer's electrical consumption during October and November of 1997 was subject to sales tax because it was not used predominately in taxpayer's production process.

II. State Gross Retail Tax—Manufacturing Exemption

Authority: *General Motors Corp. v. Indiana Dept. of State Revenue*, 578 N.E.2d 399 (Ind.Tax 1991), *aff'd*, *Indiana Dept. of State Revenue v. General Motors Corp.*, 599 N.E.2d 588 (Ind. 1992)
IC 6-2.5-2-1; IC 6-2.5-5-3(b); 6-8.1-5-1(b)
45 IAC 2.2-5-8; 45 IAC 2.2-5-12(a)

Taxpayer protests the auditor's determination that various items of equipment did not qualify for the manufacturing exemption from sales tax because they lacked an essential and integral relationship with the taxpayer's manufacturing process.

III. State Gross Retail Tax—Credit for Use Tax Paid to Foreign Jurisdictions

Authority: IC 6-2.5-3-2; IC 6-2.5-3-5

The taxpayer protests the proposed assessment of use tax on the purchase of computer equipment upon which use tax was assessed by a foreign jurisdiction.

IV. Tax Administration—Abatement of Penalty

Authority: IC 6-8.1-10-2.1(d)
45 IAC 15-11-2

Taxpayer protests imposition of a ten percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer operates a manufacturing facility in Indiana which produces high strength steel truck load floor assemblies for the automotive industry. Full scale production of the products began in the calendar year 1998; however, a limited production process began in October of 1997. At issue are the Audit Division's proposed assessments of sales and use tax on taxpayer's electrical consumption and various equipment. Additional facts are discussed below.

I. State Gross Retail Tax—Utility Exclusion

DISCUSSION

Taxpayer protests the auditor's determination that taxpayer's electrical consumption during October and November of 1997 was subject to sales tax. The Audit Division determined that December of 1997 marked the beginning of the full scale production period based upon taxpayer's records of shipments of finished parts to its customers. Taxpayer argues that the production process actually began much earlier and contends that over fifty percent (50%) of the electricity purchased between September 25, 1997 and November 24, 1997 was consumed in the production process. Given predominant use, taxpayer believes it is entitled to the one hundred percent (100%) exclusion provided by IC 6-2.5-4-5(c).

Electricity directly consumed in the direct production of other tangible personal property by a business engaged in "manufacturing, processing, refining . . ." is exempt from sales tax. IC 6-2.5-5-5.1. This exemption is applied on a pro rata basis. An exclusion is provided for sales of electricity made by public utilities if the services sold (i.e., the electricity purchased) are "consumed as an essential and integral part of an integrated process that produces tangible personal property and those sales are separately metered for the excepted uses . . . or if those sales are not separately metered but are predominately used by the purchaser for the excepted uses listed in this subdivision." IC 6-2.5-4-5(c).

Sales Tax Information Bulletin #55, which addresses the application of sales tax to sales of utilities used in manufacturing or production, provides in pertinent part:

> Use in manufacturing or one of the other listed production processes begins at the point of the first operation or activity constituting part of an integrated production process and ends at the point that the production process has altered the item to its completed form,

> including packaging, if required. To qualify for the exemption, the listed utility must be consumed as an essential and integral part of an integrated process which produces tangible personal property. In general, utilities will meet this test to the extent that they power equipment used as an essential and integral part of an integrated production process.

From the date taxpayer was awarded the contract to produce truck load assemblies for the automobile manufacturer to the date actual production of the product began, approximately two years passed. During this two-year period, taxpayer built the assembly plant and entered into a pre-production approval process period (hereinafter, "PPAP"). The PPAP is a testing phase during which inspectors from the automobile manufacturing company inspect and monitor taxpayer's production process to ensure that it will be able to meet production quantity and quality standards. If the production process fails to meet the standards, changes are made. Once the production process is approved, the PPAP phase ends and actual production of the product begins.

After its protest hearing, taxpayer interviewed numerous plant personnel who were associated with the launch of the production of the truck load assemblies. From the interviews, taxpayer determined that the PPAP period ended in late summer or early fall of 1997. Thereafter, from October to November 1997, taxpayer was engaged in limited actual production of finished parts for shipment to the automobile manufacturer in early 1998. Taxpayer fully invoiced the automobile manufacturer for the finished parts. The finished parts were installed in the automobile manufacturer's vehicles.

To further support its contention, taxpayer has provided a copy of a schedule which details the physical inventory on hand at the Indiana manufacturing facility on December 31, 1997. The inventory contained large quantities of finished assemblies, as well as large quantities of works in process. Also, taxpayer has provided a shipping history inquiry report that chronicles shipments of finished parts to its customers. Significant amounts of finished parts were shipped from the Indiana manufacturing facility in early 1998.

A review of taxpayer's utility invoices bolsters taxpayer's assertions. The utility invoices show that taxpayer's kilowatt usage increased from 43,200 KWH for the month of August, to 56,400 KWH for the month of September, to 96,000 KWH for the month of October, to 122,400 KWH for the month of November. The gradual increase in production, which precedes full scale production, is referred to by taxpayer as the "ramp up" period. During this "ramp up" period, taxpayer's production was consistent with and pursuant to the instructions taxpayer received from the automobile manufacturer as to the quantity of manufactured parts that were required.

Based upon the evidence contained in the file, and specifically the near fifty percent increase in kilowatt usage for the month of October 1997, we find that taxpayer's PPAP period ended in September of 1997, and that actual production of the manufactured product began in October of 1997. Because taxpayer was engaged in the manufacturing process and predominately used the electricity in manufacturing, taxpayer's electricity consumption for the months of October and November 1997 should have been excluded from sales tax.

FINDING

Taxpayer's protest is sustained.

II. State Gross Retail Tax—Manufacturing Exemption

DISCUSSION

Taxpayer protests the auditor's determination that various items of equipment do not qualify for exemption from sales tax, under the manufacturing exemption set forth in 45 IAC 2.2-5-8, because the equipment does not have an essential and integral relationship with the taxpayer's manufacturing process. These items include chain hoists, forklifts, forklift replacement parts, LP gas for use in the forklifts, tool room equipment, and crossover stairs.

Pursuant to IC 6-2.5-2-1, a sales tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana unless a valid exemption is applicable. Under IC 6-2.5-5-3(b), 45 IAC 2.2-5-12(a), an exemption from the state gross retail tax is provided for transactions involving manufacturing machinery, tools, and equipment if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. (Emphasis added). 45 IAC 2.2-5-8(c) defines "direct use" as use having an immediate effect on the article being produced. Property has such an immediate effect if it is an essential and integral part of an integrated process that produces tangible personal property. 45 IAC 2.2-5-8(g).

TWO CHAIN HOISTS AND A FORKLIFT

Taxpayer manufactures its product using a roll forming assembly line. At the end of the roll forming line, a robot removes the product from the line and places the product in a customer-owned container. A forklift then moves the container to the "repack" area, where two chain hoists remove the product from one customer-owned container and place the product in another customer-owned shipping container. Taxpayer's customer requires the products to be "packaged" in the customer-owned shipping container prior to shipping. Taxpayer's customer will not accept the finished product from taxpayer if the finished product is delivered in any other form or by any other means. Taxpayer cites 45 IAC 2.2-5-8(d) for the proposition that the production process does not end until "production has altered the item to its completed form, including packaging, if required", and claims that its own manufacturing process does not end until the finished product is removed to the customer-owned shipping containers. Therefore, according to taxpayer, the purchase of the two chain hoists and the use of the forklifts to move the product from the end of the roll forming line to the repack area are exempt from sales tax under the manufacturing exemption.

In *General Motors Corp. v. Indiana Dept. of State Revenue*, 578 N.E.2d 399 (Ind.Tax 1991), *aff'd*, *Indiana Dept. of State Revenue v. General Motors Corp.*, 599 N.E.2d 588 (Ind. 1992), the Tax Court held, *inter alia*, that General Motors' purchases of packing materials were exempt from sales/use tax because they were used to protect component parts that were shipped to

assembly plants and used to finish General Motors' most marketable product. *General Motors*, 578 N.E.2d at 404. In so finding, the Tax Court stated that "[a]n integrated production process terminates upon the production of the most marketable finished product, *e.g.*, the product actually marketed." *Id*. Therefore,

> [u]nder an approach focusing on the actual end product marketed, GM's packing materials used to transport component parts sold to non-GM manufacturers and those used to transport finished replacement parts would still be [subject to sales/use tax]. On the other hand, packing materials used to transport work in process parts from GM's component plants to GM's assembly plants would be exempt as an essential and integral part of GM's integrated production process of manufacturing finished automobiles.

Id. at 405 (emphasis added).

In the instant case, the customer-owned shipping container is not an integral and essential part of taxpayer's production process. The truck load assemblies that taxpayer manufactures are not "work in process parts". The fact that taxpayer's customer will not accept the finished product if it is not shipped in the customer-owned shipping containers is of no moment. Taxpayer's production process ends at the end of the roll forming line. At that point, taxpayer has produced a finished, marketable product. The removal of the product from the customer-owned container to the customer-owned shipping container is a post-production operation. As such, the forklift used to move the customer-owned container to the repack area, and the two chain hoists used to remove the product from the customer-owned container to the customer-owned shipping container are not exempt from sales/use tax under the manufacturing exemption.

FORKLIFTS, FORKLIFT REPLACEMENT PARTS, LP GAS

Taxpayer also protests the tax assessed on the forklifts used in the manufacturing process. Based upon taxpayer's argument set forth above, taxpayer asserts that sixty percent (60%) of the usage of the forklifts is production usage, and forty percent (40%) of the usage is non-production usage. As such, taxpayer maintains that 60% of the costs of the forklifts, the forklift replacement parts, and the LP gas used in the forklifts should be exempted from sales tax. The auditor determined that taxpayer's production use of the forklifts was twenty-five percent (25%). The auditor, therefore, allowed a 25% exemption for the forklifts, the forklift replacement parts, and LP gas used in the forklifts.

We have determined that taxpayer's use of the forklifts to transport the finished product from a customer-owned container to the customer-owned shipping container does not qualify for the manufacturing exemption. Furthermore, taxpayer did not provide a study showing a detailed analysis of its use of forklifts in the production process. "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC 6-8.1-5-1(b). In this instance, taxpayer has failed to meet its burden of proof that the assessment is wrong. Therefore, taxpayer is liable for the taxes due.

TOOL ROOM EQUIPMENT

Taxpayer protests the tax assessed on equipment purchased for its tool room. Taxpayer's position is that its tool room manufactures new and replacement tools used in the production process in addition to repairing and maintaining old tools and equipment. The auditor determined that the tool room equipment was purchased solely to maintain the production machinery. Taxpayer estimates that twenty percent (20%) of the tool room's activities are devoted to producing new or replacement tools (including dies, jigs, and miscellaneous parts) for use in taxpayer's production process. In support of this claim, taxpayer has provided an affidavit from its vice president of manufacturing which states:

> That 20% of [taxpayer's] tool room activities at its . . . Indiana manufacturing facility are devoted to producing new or replacement tools (including dies, jigs, and miscellaneous parts) for use in [taxpayer's] manufacturing machinery.

Taxpayer believes that because 20% of its tool room's requisition expense is attributable to the manufacture of new or replacement tools used in the production process, the equipment should be exempt from sales tax.

The regulations, at 45 IAC 2.2-5-8(h), address the issue of maintenance:

> (h) Maintenance and replacement equipment.
>
> (1) Machinery, tools, and equipment used in the normal repair and maintenance of machinery used in the production process which are predominantly used to maintain production machinery are subject to tax.
>
> (2) Replacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, are exempt from tax.
>
> -EXAMPLE-
>
> A manufacturer of sheet metal repairs and upgrades used machinery by replacing worn or broken parts and adding new elements and features available in state-of-the-art equipment. All items which become components of the upgraded machinery are exempt from tax. However, all tools and equipment used to repair or upgrade used machinery would be taxable.

Here, taxpayer has failed to provide sufficient documentation supporting its conclusion that it is entitled to a 20% exempt usage percentage. Taxpayer merely states in conclusory terms that the percentage should be 20%. Taxpayer has not performed an analysis or study indicating the percentage of tool room activity that was devoted to the manufacturing of new or replacement production equipment. We, therefore, find that taxpayer has not met the burden of proof necessary to sustain its protest as outlined under IC 6-8.1-5-1(b). "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC 6-8.1-5-1(b).

CROSSOVER STAIRS

Taxpayer protests the auditor's assessment of use tax on its crossover stairs. Taxpayer installed crossover stairs above the roll forming line to provide quick and effective access to the production equipment controls and to allow for an overhead inspection of the product as it moves through the various phases of the production process. Taxpayer maintains that the crossover stairs are essential to the production process, and therefore exempt from sales tax, because (1) taxpayer's employees must have access to the operational controls of the equipment used in the production process; and (2) taxpayer's employees must be able to inspect the roll forming line to ensure that it is operating correctly and safely.

Under IC 6-2.5-5-3(b), exemption from the state gross retail tax requires that the item in question be for the "direct use in the direct production" of the tangible property. 45 IAC 2.2-5-8(i) provides the following with respect to testing and inspection: ". . . Machinery, tools, and equipment used to test and inspect the product as part of the production process are exempt [from the state gross retail and use tax]." The example following this regulation reasons that when selected parts are removed from production, according to a schedule dictated by statistical sampling methods, and tested separate from the production line, an interrelationship between the testing equipment and the machinery on the production line is formed. The testing equipment becomes an integral part of the integrated production process and is exempt. *See* 45 IAC 2.2-5-8(i), Example.

Here, we find that taxpayer's evidence is not convincing that the crossover stairs are for the direct use in the direct production of the tangible property or a part of the testing or inspection process. Rather, the crossover stairs are used as a time saving device and a convenience to taxpayer's production process.

FINDING

Taxpayer's protests are denied. The auditor did not err in determining that the chain hoists, forklifts, forklift replacement parts, LP gas, tool room equipment, and crossover stairs do not qualify for exemption from sales tax.

III. State Gross Retail Tax—Credit For Use Tax Paid to Foreign Jurisdictions

Taxpayer protests the auditor's assessment of use tax on taxpayer's purchase of computer equipment upon which the Michigan Department of Treasury has indicated that it will assess use tax. The Michigan Department of Treasury determined that use tax should be assessed upon the computer equipment because the items were shipped to taxpayer's Michigan situs for approval prior to being shipped to Indiana.

Taxpayer claims relief from the proposed use tax assessment under IC 6-2.5-3-5 which states, in relevant part: "(a) A person is entitled to a credit against the use tax imposed on the use, storage, or consumption of a particular item of tangible personal property equal to the amount, if any, of sales tax, purchase tax, or use tax paid to another state, territory, or possession of the

United States for the acquisition of that property." This credit, if available, is applied against the Indiana tax applied under IC 6-2.5-3-2.

Here, the computer equipment was first shipped to taxpayer's situs in Michigan, and then shipped to taxpayer's facility in Indiana. The Michigan Department of Revenue assessed use tax on the computer equipment because the items were shipped to taxpayer's Michigan situs for approval prior to being shipped to the Indiana facility. Subsequent to its protest hearing, taxpayer submitted evidence that use tax was paid on the purchase of the computer equipment to the Michigan Department of Revenue. Taxpayer's protest is sustained to the extent of a credit against the Indiana use tax for use tax paid in Michigan.

FINDING

Taxpayer's protest is sustained, subject to verification by the Audit Division.

IV. Tax Administration— Abatement of Penalty

DISCUSSION

Taxpayer protests the imposition of a ten percent (10%) negligence penalty.

IC 6-8.1-10-2.1(d) states that if a person subject to the negligence penalty imposed under said section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty. 45 IAC 15-11-2 defines negligence as the failure to use reasonable care, caution or diligence as would be expected of an ordinary reasonable taxpayer. Negligence results from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or Department regulations.

In order to waive the negligence penalty, taxpayer must prove that its failure to pay the full amount of tax due was due to reasonable cause. 45 IAC 15-11-2. Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ." 45 IAC 15-11-2(c). In determining whether reasonable cause existed, the Department may consider the nature of the tax involved, previous judicial precedents, previous department instructions, and previous audits. *Id*.

In the instant case, the Audit Division imposed the penalty because it found that taxpayer appeared to have no understanding of taxable versus nontaxable purchases. Although taxpayer is subject to its first audit by the Department, taxpayer has, nevertheless, failed to demonstrate that, in the area of concern raised by the Department, it exercised the degree of reasonable care required to justify waiving the ten percent negligence penalty. Waiver of the penalty is inappropriate.

FINDING

Taxpayer's protest is respectfully denied.

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